

# EMPLOYEE VS. INDEPENDENT CONTRACTOR

*Where's the line?*

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# **EMPLOYEE vs. INDEPENDENT CONTRACTOR**

## **Where's the line?**

When a worker performs services and receives some form of remuneration, an important question is whether the remuneration is subject to employment taxes. The answer depends on whether the worker is an employee or an independent contractor. This determination of the worker's status depends on certain facts . . . facts which define the business and the relationship of the parties, at the time the services are rendered.

Generally, an employee, sometimes referred to as a common law employee works for and performs services under the control of the party who pays for the services. On the other hand, an independent contractor is an individual in business for himself or herself, and performs the services free of control from the party who pays for the services.

Employment taxes apply solely to the remuneration paid to workers classified as employees. The distinction between employees and independent contractors is important because an employer must deduct Social Security/Medicare taxes from their employee's checks and must pay an equivalent amount to the Social Security Administration. The employer's obligation is to deduct Federal income tax withholding, to deduct and "match" Social Security and Medicare taxes, and to pay Federal unemployment tax. In addition, there may be state income taxes to be withheld and the employer or employee may have to pay state unemployment compensation contributions and state disability insurance. These types of taxes are typically not withheld or deposited from payments made to independent contractors.

If an individual is working as an independent contractor, the "employer" does not make Social Security/Medicare deductions, and the independent contractor must pay his or her own "self-employment taxes" along with income tax on earnings.

Basically, an independent contractor is an independent business person who runs his or her own business but who performs work for another business. An employee is hired by a company to perform specific work at the direction of the employer.

The problem we have seen is that perhaps years later, the IRS, Department of Labor or state taxing authorities may classify the independent contractor as an employee, leading to retroactive overtime pay, retirement benefits and medical claims for job-related injuries. In turn, an independent contractor's job-related expense write-offs may be disallowed or subject to the 2% of Adjusted Gross Income rule on the 1040 which can create issues with how the independent contractor's past tax returns have been filed and any taxes paid or refunded.. These issues may not arise until after a substantial period of time has passed for a variety of reasons.

The employer or the independent contractor for that matter can make a request to the I.R.S. to seek determination on whether a worker is an employee. The only requirement for this determination is to have filed a detailed Form SS-8 (*Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*).

### **The Internal Revenue Provides Some Guidance**

When determining under common law whether an individual is an employee or an independent contractor, the I.R.S. stresses that ALL evidence of the degree of control and degree of independence must be considered. The current I.R.S. official guidance, in Publication 15-A, *Employer's Supplemental Tax Guide - Supplement to Circular E*, indicates that facts which provide evidence of the degree of control and independence fall into three major categories: behavioral control, financial control, and the type of relationship between the parties, as follows:

**I.) Behavioral Control Facts** that indicate whether the business has the right to direct and control how the worker does the task for which the worker is hired include the type and degree of:

- a. **Instructions the business gives the worker.** An employee is generally subject to the business' instructions about when, where and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the RIGHT to control how the work results are achieved.

- b. **Training the business gives to the worker.** An employee may be trained to perform services in a particular manner. Independent contractors, however, ordinarily use their own methods.

**II.) Financial Control Facts** that indicate whether the business has a right to control the business aspects of the worker's job include:

- a. **The extent to which the worker has unreimbursed business expenses.** Independent contractors are more likely to have unreimbursed expenses than employees.
- b. **The extent of the worker's investment.** An independent contractor often has a significant investment in the "facilities" he or she uses in performing services for someone else, but this is not mandatory.
- c. **The extent to which the worker makes services available to the relevant market.** Employees tend to work for a single business.
- d. **How the business pays the worker.** An employee generally is paid by the hour, week or month. An independent contractor usually is paid by the job. However, it is common in some professions, such as law, to pay independent contractors at an hourly rate.
- e. **The extent to which the worker can realize a profit or incur a loss.** An independent contractor can make a profit or loss.

**III.) Type of Relationship Facts** that indicate the type of relationship between the parties includes:

- a. Written contracts describing the type of relationship the parties intended to create.
- b. Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay.

- c. The permanency of the relationship. If one engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence the intent was to create an employer-employee relationship.
- d. The extent to which services performed by the worker are a key aspect of the regular business of the company. If a worker provides services that are a key aspect of the company's business activity, it is more likely that the company will have the right to direct and control his or her activities. This would indicate an employer-employee relationship.

Employers can avoid the high costs of having a service provider's designation changed from independent contractor to employee by vigorously applying the 20 common-law factors. When reviewing these factors, businesses should not place more emphasis on those factors in its favor than those that are not.

### Common-Law Factors Indicating Employee Status

1. **Instructions.** A worker who must comply with other persons' instructions about when, where and how he or she is to work is ordinarily an employee. This factor is present when the person for whom the services are performed has the right to *require* compliance.
2. **Training.** Requiring an experienced employee to work with the worker, corresponding with the worker, requiring the worker to attend meetings or using other training methods indicates the person for whom the services are performed wants them done in a particular method or manner.
3. **Integration.** Integrating the worker's services into the business operations generally shows that he or she is subject to direction and control. When the success or continuation of a business depends to an appreciable degree on the performance of certain services, the workers who perform them must necessarily be subject to a certain amount of control by the business owner.
4. **Services rendered personally.** If the worker must render the services personally, presumably the person for whom they are performed is

- interested in the methods used to accomplish the work as well as in the results.
5. ***Hiring, supervising and paying assistants.*** If the person for whom the services are performed hires, supervises and pays assistants, that generally shows control over the workers on the job. However, if one worker hires, supervises and pays the other assistants under a contract in which the worker agrees to provide materials and labor and is responsible only for attaining a result, this indicates independent contractor status.
  6. ***Continuing relationship.*** A continuing relationship between the worker and the person for whom the services are performed indicates that an employer-employee relationship exists. This may be the case when work is performed at frequently recurring although irregular intervals.
  7. ***Set hours of work.*** If the person for whom the services are performed establishes set work hours, this indicates control.
  8. ***Full-time required.*** If the worker must devote himself or herself substantially full-time to the business of the person for whom the services are performed, the latter has control over the amount of time the worker spends working and implicitly restricts the worker from performing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
  9. ***Doing work on employer's premises.*** If the individual performs the work on the premises of the person for whom the services are performed, this suggests control over the worker, especially if the work could be performed elsewhere. Work performed off the premises, such as at the worker's office, indicates some freedom from control. However, this fact by itself does not mean the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the premises. Control over the place of work is indicated when the person for whom the services are performed has the right to compel the worker to travel a designated route, to canvass a territory within a certain time frame, or to work at specific places.

10. ***Order or sequence set.*** If a worker must perform services in the order or sequence set by the person for whom the services are performed, that factor shows the worker is not free to follow his or her own pattern of work but must follow the established routines and schedules of the employer. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set it infrequently. Retaining the right to do so is sufficient to show control.
11. ***Oral or written reports.*** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a certain degree of control.
12. ***Payment by hour, week or month.*** Payment by one of these three methods generally points to an employer-employee relationship, provided this method is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission basis generally indicates the worker is an independent contractor.
13. ***Payment of business or travel expenses.*** If the person for whom the services are performed generally pays the worker's business and travel expenses, he or she is ordinarily an employee. To control expenses, an employer usually retains the right to regulate and direct the worker's business activities.
14. ***Tools and materials.*** The fact the person for whom the services are performed furnishes significant tools, materials and other equipment tends to show the existence of an employer-employee relationship.
15. ***Significant investment.*** If the worker invests in facilities not typically maintained by employees (such as an office rented at fair value from an unrelated party) and uses them to perform services, that tends to indicate the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person for whom the services are performed for such facilities. Accordingly, an employer-employee relationship exists.
16. ***Realization of profit or loss.*** A worker who can realize a profit or suffer a loss as a result of his or her services (in addition to the profit or loss

ordinarily realized by employees) is generally an independent contractor. A worker who cannot realize a profit or suffer a loss is an employee. For example, if a worker is subject to a real risk of economic loss due to a significant investment or a bona fide liability for expenses, such as salary payments to unrelated employees, that indicates the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus is not sufficient to support independent contractor treatment.

17. ***Working for more than one entity.*** If a worker performs more than minimal services for multiple unrelated persons or companies at the same time, that factor generally indicates the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each, especially where the two are connected.
18. ***Making service available to the general public.*** The fact a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. ***Right to discharge.*** The right to fire a worker is a factor indicating the worker is an employee and the person with the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as he or she produces a result that meets the agreed contract specifications.
20. ***Right to terminate.*** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time without incurring liability, this indicates an employer-employee relationship.

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**Resources:**

- [\*\*Tax Topic 762 Basic Information\*\*](#)  
To determine whether a worker is an independent contractor or an employee, you must examine the relationship between the worker and the business. All evidence of control and independence in this relationship should be considered. The facts that provide this evidence fall into three categories Behavioral Control, Financial Control, and the Type of Relationship itself.
- [\*\*Publication 1976, Section 530 Employment Tax Relief Requirements\*\*](#) (PDF)  
Section 530 provides businesses with relief from Federal employment tax obligations if certain requirements are met.
- [\*\*IRS Internal Training: Employee/Independent Contractor\*\*](#) (PDF)  
This manual provides you with the tools to make correct determinations of worker classifications. It discusses facts that may indicate the existence of an independent contractor or an employer-employee relationship. This training manual is a guide and is not legally binding. If you would like the IRS to make the determination of worker status, please file IRS Form SS-8.
- [\*\*Form SS-8\*\*](#) (PDF)  
Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding
- [\*\*Publication 15-A\*\*](#)  
The Employer's Supplemental Tax Guide has detailed guidance including information for specific industries.
- [\*\*Publication 15-B\*\*](#)  
The Employer's Tax Guide to Fringe Benefits supplements Circular E (Pub. 15), Employer's Tax Guide, and Publication 15-A, Employer's Supplemental Tax Guide. It contains specialized and detailed information on the employment tax treatment of fringe benefits.

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